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In the Supreme Court of the United States

OCTOBER TERM, 1933

No. 187

ARTHUR M. BROWN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 64–69) is reported in 22 B.T.A. 678. The opinion of the Circuit Court of Appeals (R. 274–281) is reported in 63 F. (2d) 66.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 6, 1933. (R. 282–283.) A petition for rehearing was denied March 21, 1933. (R. 283.) The petition for a writ of certiorari was filed June 19, 1933, and granted October 9, 1933. (R. 287.) The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Board of Tax Appeals and the court below erred in holding that the petitioner, accounting on the accrual basis, was obliged to report the full amount of the so-called overriding commissions received in 1923, 1925, and 1926, without deduction, either as a reserve or otherwise, on account of a contingent liability to refund certain portions of such overriding commissions in later years in the event of cancellation or reinsurance.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 29–33.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 56–63) are not controverted and may be summarized as follows:

From 1896 to 1904 the petitioner, an individual residing in California, together with his father, Edward Brown, and his brother Herbert H. Brown, was engaged in business as a general insurance agency. After the death of the father in 1904 and until 1922 the business was carried on by the petitioner and his brother. The latter died in 1922, and the business was thereafter conducted by the petitioner alone until January 1, 1924, when the petitioner's son, Arthur M. Brown, Jr., was admitted as a partner. This relationship continued throughout the taxable years 1925 and 1926. The business was at all times carried on under the name Edward Brown & Sons. (R. 56.)

During the years in question the firm of Edward Brown & Sons acted as general agent in a number of western States and Federal territories for six fire insurance companies. The firm's relationship with certain of these companies was fixed by oral conversations with their officers, and with other companies, by written agreements. (R. 60.)

The duties performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; issued, countersigned, and cancelled policies; received and receipted for premiums; surveyed and accepted or rejected risks; represented its principals on the local Board of Fire Underwriters; rendered all reports required of its principals by local authorities; paid the necessary license fees and taxes, and "generally attended to all of the affairs of its principals in the territory in which it operated." (R. 60–61.)

The firm received as its compensation, in addition to a percentage of the net profits on business written in its territory, so-called "overriding commissions," which are stated percentages of the net premiums written. (R. 61.)

All policies written by the firm since 1917 were for periods of one, three, or five years. These policies were subject to cancellation. If the insurance company cancelled, it was obligated to refund a ratable proportion of the premium for the unexpired term of the policy; if the assured cancelled, the company was entitled to retain the customary short-period

rate for the time the policy continued in force. (R. 61–62.)

The firm made remittances to its principals on monthly balances, crediting itself, among other things, with the overriding commissions due on the business written during the month, and charging itself, among other things, with a proportional part of any overriding commissions previously received in respect of any business which was cancelled or reinsured in another company during the month. (R. 62.)

The books of the firm show the gross premiums written and the premiums cancelled, the percentage of cancellations approximating 22 percent, based upon five-year periods from 1919–1923 to 1922–1926. (R. 62.)

The books of account were kept on the accrual basis. Overriding commissions on new business were accounted income of the year in which the business was written, and refunds of overriding commissions on account of cancellations or reinsurance were accounted expense of the year of cancellation or reinsurance. (R. 63.)

At the close of 1923, for the first time, a liability account denominated "Return Commissions" was set up on the firm's books. This was for the purpose of recording the firm's contingent liability to refund to insurance companies a portion of the overriding commissions received during the year on account of future cancellations and the reinsurance of business written during the year. At the close of each of the

years 1924 to 1926, inclusive, the credit balance in the account was adjusted to reflect the same proportion of the overriding commissions received during the year as the total fire premiums cancelled in the preceding five-year period bore to the gross fire premiums written in the same period. (R. 63.)

The petitioner claimed as a deduction for 1923 the amount credited to the contingent liability account at the close of that year. Similar deductions were claimed in respect of partnership net income for 1925 and 1926. All three deductions were disallowed by the Commissioner. The Board of Tax Appeals approved the action of the respondent. The Circuit Court of Appeals affirmed the decision of the Board. This Court granted certiorari limited to the question of deduction for reserves. (R. 287.)

SUMMARY OF ARGUMENT

The overriding commissions were income in the year in which the policies to which they related were written, even though they might have to be refunded in part at some future time in the event of cancellation or reinsurance. Prior to 1923 return commissions were properly treated as accrued expenses when cancellation or reinsurance took place, and the Commissioner contends that they should have been so treated in subsequent years. In 1923 the firm set up a "Return Commissions" account to record its contingent liability to repay a portion of the commissions received. The petitioner now seeks to deduct sums credited to this account in each of the years involved.

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In order to be deductible, an expense must have been "paid or incurred" during the taxable year. Nothing in the statutes permits the deduction of expenses which may be incurred in the future. Congress, in sanctioning the use of the accrual method of accounting, did not expand the class of deductible expenses or authorize the deduction of expenses not yet accrued. An expense is not accrued, within the meaning of the Acts, until all the events have occurred which establish the liability, although it is not necessary that payment be presently due or the amount definitely ascertainable. The great weight of authority supports this proposition.

While conservative accounting principles may require the establishment of the reserve in question, we are concerned only with the deductions expressly authorized by Congress. In sanctioning the deduction of reserves for bad debts, Congress has clearly indicated that reserves for other contingencies may not be deducted. There is no true analogy between the reserves for return commissions and the reserve for redemption of trading stamps (Regulations 62, Art. 91) or the special provisions for return of income derived from long term contracts. (Regulations 62, Art. 36.) Moreover, the application of these regulations is restricted to the matters there specified.

The statutory requirement that a taxpayer's return clearly reflect income refers to income as defined by the Acts, and not to the theorist's concept of income. The method of accounting employed by the firm prior to 1923 accurately reflected income as defined by the

statute. It may be doubted whether the new method reflects income any more accurately. In any event, it is within the discretion of the Commissioner to require that the taxpayer adhere to an established method of returning income when that method satisfies the statutory requirements.

The petitioner suggests as an alternative that he be permitted to report as income only the portion of the commissions earned in each year, apportioning commissions over the lives of the policies. This method is required of certain types of insurance companies, but is limited to such companies and cannot be extended to other classes of taxpayers. Moreover, the record fails to show that the commissions received are properly attributable to services performed by the petitioner after the policies have been written, or if so, to what extent. Finally, since the proposed method of accounting has neither been adopted by petitioner nor required by the Commissioner, there seems to be no reason why it should be accepted now.

ARGUMENT

The full amount of the overriding commissions received by the firm has consistently been treated as income in the year when the policies were written (R. 63) and we do not understand the petitioner to contend that this practice was improper.[1] The fact that some portion of the commissions collected might

[1] As an alternative, the petitioner suggests a wholly different method of accounting, which he contends would more accurately reflect income. This method is discussed at pages 25–27, *infra*.

be refundable in later years in the event of cancellation or reinsurance did not serve to rob them of their quality as income. Refunds were made only if and when cancellation or reinsurance took place, which might be anywhere from one to five years after the commissions were received. In the meantime, the firm's right to the commissions was absolute, and it was under no restriction, contractual or otherwise, as to their disposition, use or enjoyment. Consequently, it would seem clear that these commissions constituted income in their full amount. As this Court said in *North American Oil Consolidated* v. *Burnet*, 286 U.S. 417, 424:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

See also *Board* v. *Commissioner*, 51 F. (2d) 73 (C.C.A. 6th), certiorari denied, 284 U.S. 658; *Ford* v. *Commissioner*, 51 F. (2d) 206 (C.C.A. 6th), certiorari denied, 284 U.S. 666; *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d), 990 (C.C.A. 7th), certiorari denied, 284 U.S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D.C.). Cf. *Burnet* v. *Sanford & Brooks Company*, 282 U.S. 359.

Prior to 1923, commissions returned on account of cancellation or reinsurance were likewise treated as expenses of the year of such cancellation or reinsurance.

In 1923, for the first time, there was set up on the books of the firm a liability account denominated "Return Commissions," the purpose of which was to record a contingent liability to refund to the companies a portion of the commissions received during the year if and when the policies written during that year were cancelled or reinsured. The petitioner now seeks to take as a deduction from gross income the sums credited to this account, in lieu of deducting the return commissions in the year of actual cancellation or reinsurance.

It is asserted, in the first place, that the Commissioner's method of treating return commissions is erroneous because he has regarded them as cash items although income is reported on the accrual basis. (Br., p. 40.) The record does not support this statement, and we believe it to be wholly incorrect. The Board of Tax Appeals found as a fact (R. 63) that "refunds of overriding commissions, on account of policy cancellations or reinsurance, have been accounted expense of the year of cancellation or reinsurance." This can only mean that refunds were treated as accrued expenses in the year of cancellation or reinsurance, irrespective of whether they were actually paid to the companies then or later. Since the firm made monthly remittances to its principals, it is probable that in most instances accrual and payment were almost simultaneous, but this does not prevent the refunds being regarded as accrual items, or indicate that the Commissioner seeks to have them treated in any other manner.

The applicable regulations (Regulations 62, Article 23, *infra*, p. 31) require that all items of gross income and deductions be treated with reasonable consistency, and it is not to be supposed that the Commissioner has so far departed from established practice as to require that income be reported on the accrual basis and expenses on the cash basis, unless the record plainly shows that to have been the fact.

The petitioner is seeking a deduction from what is admittedly gross income. Such deductions under the Revenue Acts are a matter of legislative grace, and the taxpayer assumes the burden of showing that the facts bring his case squarely within the provisions of the statute. *Reinecke* v. *Spalding*, 280 U.S. 227, 233; *Botany Worsted Mills* v. *United States*, 278 U.S. 282, 289–290; *Burnet* v. *Houston*, 283 U.S. 223, 227. The only deductions to which the petitioner is entitled are specified in Section 214 (a) of the Revenue Acts of 1921, 1924 and 1926 (*infra*, p. 30). This section makes no provision whatever for the deduction of future expenses, no matter how accurately they may be foreseen.

Section 214 (a) (1) permits the deduction of "all the ordinary and necessary expenses *paid or incurred* during the taxable year." (Italics ours.) Thus, under the plain terms of the statute, unless the expense is paid or incurred within the taxable year it is not deductible. We think that the refunds in question may properly be classified as ordinary and necessary business expenses and that, since the taxpayer is on the accrual basis of accounting, there

may be deducted amounts presently refundable by reason of cancellations occurring during the taxable year, even though payment does not take place until some later time. The reason for this is that under the agency contracts a present liability to refund accrues when a policy is cancelled. But there is nothing in Section 214 (a) which sanctions the deduction of estimated future refunds where no present liability has actually been incurred.

The real question in issue is whether a liability to refund a portion of the overriding commissions may be said to have accrued, within the meaning of the revenue laws, prior to the cancellation or reinsurance of the policies to which the commissions relate. In contending that such liability accrues as soon as each policy is written, the petitioner appears to rely chiefly on Section 200 (4) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 228, which states that—

> * * * the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212;[2] * * *

[2] Section 200 (d) of the Revenue Acts of 1924 and 1926 is the same, with the added provision that deductions shall be taken in the year in which paid or incurred "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

The Committee on Ways and Means of the House of Representatives had this comment to make on the change (H.Rep. No. 179, 68th Cong., 1st Sess., pp. 10–11):

> (2) In subdivision (d) of this section authority is granted to the Commissioner to allow or require

and on Section 212 (b) of the several Revenue Acts (*infra*, p. 29), which provides in part:

> The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if * * * the method employed does not clearly reflect income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

It is urged that because the firm now carries on its books an account recording its contingent liability to return a portion of the commissions received, and because the estimated liability has been found to approximate closely the amounts actually refunded in each year, this method of accounting may be fol-

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deductions and credits to be taken as of a year other than that in which "paid" or "accrued" when, in his opinion, it is necessary in order *to clearly reflect the* income. The Revenue Act of 1921 in sections 214 (a) (6) and 234 (a) (4) authorizes the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, it is necessary to clearly reflect the income. The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should.

This statement is repeated in S.Rep. No. 398, 68th Cong., 1st Sess., pp. 10–11.

lowed in computing income tax, as one which is "regularly employed" and which clearly reflects income. It is apparent, however, that in enacting the sections above quoted Congress did not intend that any accounting system which the taxpayer might choose to adopt should be accepted for tax purposes, or that items of expense should be deducted in any manner other than that specified in the Acts. Legislative recognition of the accrual method merely permits the taxpayer to report income when accrued rather than when actually received, and to deduct expenses when incurred instead of when actually paid.

In order to be accrued, and therefore deductible from gross income, a liability must be fixed and absolute. It is essential that all the events shall have occurred which establish the liability, even though payment may not be presently due or the amount be definitely ascertained or ascertainable. *United States* v. *Anderson*, 269 U.S. 422; *American National Co.* v. *United States*, 274 U.S. 99; *Lucas* v. *American Code Co.*, 280 U.S. 445; *Block & Kohner Mercantile Co.* v. *United States*, 37 F. (2d) 877 (C.C.A. 8th); *Vang* v. *Lewellyn*, 35 F. (2d) 283 (C.C.A. 3d); *S. Naitove & Co.* v. *Commissioner*, 32 F. (2d) 949 (App.D.C.); *Schuster & Co.* v. *Williams*, 283 Fed. 115 (C.C.A. 7th). As stated in *Block & Kohner Mercantile Co.* v. *United States*, *supra*, p. 879:

> "Under the accrual system an expense accrues when all the events have occurred from which liability is determined and the liability has become fixed, even though payment is not yet due."

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The petitioner apparently concedes that no liability accrued on any individual policy until it was cancelled or reinsured, but argues that since the gross amount which the firm would be required to return on policies written in any one year could be foretold with reasonable accuracy there was in fact an accrued rather than a contingent liability in that amount. This argument, we submit, confuses the idea of accrual with the ability to estimate the amount of the liability which may at some future time be incurred. While sound accounting principles may require the setting up of a reserve for a contingency of this character, accountants are not bound by the statutory restrictions applicable to taxpayers. It is difficult to see how an estimated liability composed of numerous contingent items can be other than contingent within the meaning of the revenue laws. Cf. *Ocean Accident & Guarantee Corp., Ltd.* v. *Commissioner*, 47 F. (2d) 582 (C.C.A. 2d).

We question, further, whether the amounts which the petitioner seeks to deduct constitute reserves, strictly speaking. So far as the record discloses, no sums were actually set aside or segregated to provide for the contingency. The amounts in question were apparently not withdrawn from the business, and there was no limitation on the free use and enjoyment of them.[3] There was merely a bookkeeping

[3] Even had the sums been actually withdrawn and set aside, they would not have been deductible. See *Cleveland Ry. Co.* v. *Commissioner*, 36 F. (2d) 347 (C.C.A. 6th); *Desco Corp.* v. *United States*, 55 F. (2d) 411 (D.Del.).

entry "to record the firm's contingent liability * * *." (R. 63.)

But even if we assume that the book entries constituted a reserve, such a reserve is not deductible under the statute. Designation of the account as a "reserve" account does not avoid the difficulty arising out of the fact that the petitioner is seeking to accrue an expense before the events have occurred which establish the liability. As this Court stated in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, p. 452:

> The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions.

Among the cases cited in support of this proposition is *Appeal of Uvalde Co.*, 1 B.T.A. 932, where the Board of Tax Appeals held that the taxing Acts make no provision for the deduction of future expenses, however accurately the same may be estimated. The Court also cited with apparent approval *Kaufmann Department Stores, Inc.*, v. *Commissioner*, 11 B.T.A. 949, where the Board quoted from its earlier opinion in *Appeal of William J. Ostheimer*, 1 B.T.A. 18, as follows (pp. 953–954):

> In order that an item may be accrued, however, a liability must actually be incurred in the taxable year. *Schuster & Co.* v. *Williams*, 283 Fed. 115. The statute recognized the accrual basis of making returns by providing for the deduction of expenses *incurred* but not paid. It is apparent that no liability in praesenti was incurred under the

> terms of the lease in question in the years 1918 and 1919 however well known it might have been that a liability in some amount would be incurred at some time in the future. * * *
>
> While it may have been sound business practice on the part of the taxpayer to set up a reserve out of his income to meet a *future* liability, such a reserve is not deductible in determining net income.

The Circuit Court of Appeals for the Third Circuit affirmed the decision of the Board in the *Kaufmann* case (34 F. (2d) 257), adopting the Board's opinion as its own.

The courts, in a long line of cases, have agreed with this view and have denied taxpayers deductions of the kind here sought. Similarly, the Board of Tax Appeals, in over fifty decided cases, has consistently

[4] In addition to the cases cited above, see: *Readers Pub. Corporation* v. *United States*, 40 F. (2d) 145; *Malleable Iron Range Co.* v. *United States*, 62 C.Cls. 425; *Earle* v. *Commissioner*, 38 F. (2d) 965 (C.C.A. 1st); *Lane Construction Co.* v. *Commissioner*, 49 F. (2d) 1080 (C.C.A. 2d), affirming, *per curiam*, 17 B.T.A. 826; *Kay Manufacturing Co.* v. *Commissioner*, 53 F. (2d) 1083 (C.C.A. 2d), affirming, *per curiam*, 18 B.T.A. 753; *Highland Milk Condensing Co.* v. *Phillips*, 34 F. (2d) 777 (C.C.A. 3d), certiorari denied, 280 U.S. 608; *Sells Lumber & Manufacturing Co.* v. *Commissioner*, 41 F. (2d) 363 (C.C.A. 6th); *Lichtenberger-Ferguson Co.* v. *Welch*, 54 F. (2d) 570 (C.C.A. 9th); *Spring Canyon Coal Co.* v. *Commissioner*, 43 F. (2d) 78 (C.C.A. 10th), certiorari denied, 284 U.S. 654; *Thomas Cronin Co.* v. *Lewellyn*, 9 F. (2d) 974 (W.D. Pa.); *Consolidated Tea Co.* v. *Bowers*, 19 F. (2d) 382 (S.D.N.Y.).

denied deductions of this type.[5] The first of these cases was decided October 21, 1924. Since that time Congress has enacted the 1926, 1928 and 1932 Revenue Acts, which carried forward without substantial change the provisions here involved. This would indicate legislative approval of the Board's interpretation of the statutes.

Neither *United States* v. *Anderson*, 269 U.S. 422, *supra*, nor *American National Co.* v. *United States*, 274 U.S. 99, *supra*, relied upon so strongly by the petitioner, establishes any different principle. Those cases were distinguished by this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, and the distinction there made is applicable here. There it was said (p. 452):

> The case at bar is unlike *United States* v. *Anderson*, 269 U.S. 422. There, the liability for the munitions tax at a fixed rate on the business done in 1916 had confessedly accrued in that year and was a charge on the business of that year, although the exact amount due may not have been then ascertainable and the tax was not payable until 1917. It is also unlike *American National Co.* v. *United States*,

[5] A large group of these cases may be found in 331 C.C.H. 797–802 under the title of "Reserves". And for example see: *Appeal of William J. Ostheimer*, 1 B.T.A. 18; *Appeals of Arthur H. Leonard et al.*, 4 B.T.A. 1221; *Appeal of W. S. Buck Mercantile Co.*, 6 B.T.A. 285; *Harris-Emery Co.* v. *Commissioner*, 10 B.T.A. 297; *Jahncke Shipbuilding Co.* v. *Commissioner*, 11 B.T.A. 479; *Landesman-Hirschheimer Co.* v. *Commissioner*, 15 B.T.A. 64; *Virginia Table Co.* v. *Commissioner*, 20 B.T.A. 388; *Reuben H. Donnelly Corporation* v. *Commissioner*, 22 B.T.A. 175.

> 274 U.S. 99. There, the bonus contract provided definitely for the payment of a fixed amount. It was *debitum in praesenti, solvendum in futuro.* * * *

It may be, as petitioner contends, that sound accounting practice requires that current income be reduced by reserves for contingencies which reasonably can be reduced to figures. This, however, is conservative accounting as distinguished from legal accounting. Cf. Montgomery, *Income Tax Procedure* (1927 ed.), Vol. 1, p. 266; Kester, *Accounting, Theory and Practice*, Vol. II, pp. 445–446; Finney, *Principles of Accounting*, Vol. II, Ch. 45, p. 5, *et seq.* We are not here concerned with conservative accounting practice, but with the method of ascertaining taxable income. The Acts have their own criteria of net income for tax purposes, namely, gross income less specified deductions. As was said by this Court in *Weiss* v. *Wiener*, 279 U.S. 333, 335:

> The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer. They do not charge for appreciation of property or allow a loss from a fall in market value unless realized in money by a sale. *United States* v. *S. S. White Dental Co.*, 274 U.S. 398, 401. A stockholder does not pay for accumulated profits of his corporation unless he receives a dividend.

> That is the general principle upon which these laws go. It is true that they allow for obsolescence of buildings, &c., where the loss is of materials, not of money; *but there as elsewhere the loss must be actual and present, not merely contemplated as more or less sure to occur in the future.* * * * (Italics ours.)

It is significant that the only reserves for the deduction of which express provision has been made in the statutes here involved are the reserves for bad debts, the allowance of which is made discretionary with the Commissioner, and the reserves permitted in the case of certain insurance companies by Section 234 (a) (10) and (11) and Section 245 (a) (2) and (4) of the 1921 Act and corresponding provisions of later Acts.[6] We submit that in sanctioning the deduction of these specified reserves Congress has plainly indicated that reserves for other contingencies are not deductible.[7]

[6] The statutory allowances for depreciation, obsolescence and depletion (Sec. 214 (a) (8) and (10), *infra*, p. 30) are not really reserves. These allowances are not like the replacement reserves required by conservative accounting. Cf. *Weiss* v. *Wiener*, 279 U.S. 333.

[7] The petitioner argues that since insurance companies are allowed to deduct reserves for unearned premiums which may have to be refunded, he should be allowed to deduct the similar reserves set up on his books. The insurance reserve referred to in the Acts has, however, a special technical meaning in the law of insurance and is limited in its application to insurance companies. *Maryland Casualty Company* v. *United States*, 251 U.S. 342, 350; *United States* v. *Boston Insurance Company*, 269 U.S. 197; *New York Insurance Company* v. *Edwards*, 271 U.S. 109. It can have no application to the petitioner, who is not an insurance company.

Under Section 13 (d) of the Revenue Act of 1916, c. 463, 39 Stat. 756, 771, the Treasury Department promulgated T.D. 2433 (19 Treasury Decisions 5) which permitted deduction of reserves to cover liabilities accrued but not presently payable. This ruling expressly stated (pp. 6–7):

> The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

It will be observed that under this Act and regulation reserves for bad debts were not deductible. See Holmes, *Federal Income Taxes* (1917 ed.), pp. 299–301. It is a matter of common knowledge that in an established business future losses on worthless debts may, on the basis of past experience, be estimated with reasonable accuracy. Yet it was not until the Revenue Act of 1921 that Congress for the first time gave taxpayers the right to deduct reserves for bad debts. See Section 214 (a) (7) of the Revenue Act of 1921 (*infra*, p. 30). Cf. Section 214 (a) (7) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1066. See also H. Rep. No. 350, 67th Cong., 1st Sess., p. 11. The reference to reserves for bad debts on page 54 of the petitioner's brief is, therefore, misleading.

Neither the 1918 Act nor the regulations promulgated thereunder permitted the deduction of anything other than "debts ascertained to be worthless and charged off within the taxable year." See Article 151, Regulations 45 (1920 ed.). We submit that since it required an amendment to the statute to enable taxpayers to deduct bad debt reserves, it requires similar legislative action to enable the petitioner to take the deduction here sought.

The petitioner also likens the reserve for return commissions to the provision in Article 91 of Regulations 62, permitting a taxpayer who issues trading stamps or premium coupons redeemable in merchandise or cash to subtract from gross income the amount estimated to be necessary to redeem such part of the total issue of stamps or coupons as will probably be presented for redemption. It seems clear, however, that this regulation deals with a present liability, since the stamps or coupons are redeemable at any time on presentation. Here there must be more than a request for the return of commissions; there must be a cancellation or reinsurance of the policies.

Reference is also made to Article 36 of Regulations 62, which permits gross income derived from long-term contracts to be reported on the basis of percentage of completion. This article creates a limited exception to the general rule. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359. The reserve which petitioner seeks to deduct is recognized neither by statute nor by regulation.

The petitioner contends that unless he is allowed the deductions claimed, true income is not reflected, and refers to the opinion of this Court in *United States* v. *Anderson*, 269 U.S. 422, *supra*, where it was said (p. 440) that recognition of the accrual basis of accounting was designed—

> * * * to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses *incurred* in and properly attributable to the process of earning income during that period; * * *. (Italics ours.)

He argues that the refunds in later years are properly attributable to the commissions received in the taxable years. But the refunds in question do not constitute expenses contributing to the earning of income. Moreover, the future refunds were not *incurred* in the taxable year and were therefore clearly not the kind of expenditures to which this Court was referring.

A somewhat similar argument was advanced by the Government in *Lucas* v. *Ox Fibre Brush Co.*, 281 U.S. 115, and was rejected by this Court in the following language (p. 120):

> * * * this section [Sec. 212 (b), *infra*, p. 29] does not justify the Commissioner in allocating to previous years a reasonable allowance as compensation for services actually rendered, when the compensation was properly paid during the taxable year and the obligation to pay was incurred during that year and not

> previously. In the present instance, the expense could not be attributed to earlier years, for it was neither paid nor incurred in those years. There was no earlier accrual of liability. It was deductible in the year 1920 or not at all. * * *

The theoretically perfect system of accounting, on which income earned and the expenditures made to earn it appear in one return, is impossible in a system of taxation which calls for the net result of the taxpayer's transactions during a fixed accounting period. It is of the essence of our system of taxation that it should produce revenue ascertainable and payable to the Government at regular intervals. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365. The accountant's idea of perfect bookkeeping must give way to the need for periodic revenue. The requirement in Section 212 (b) that the system of accounting clearly reflect income refers to income as defined by statute and not to the theorist's concept of income.

We submit that the system consistently employed by the firm up to 1923 accurately reflected income as defined by the statute. See Regulations 62, Article 111, *infra*, p. 32. The petitioner now seeks to abandon a practice which has been established for years and which has received the Commissioner's approval. We submit that the Act makes it discretionary with the Commissioner to permit or forbid the change, assuming that the new method satisfies the statutory requirements, which we do not concede. In such a

case this Court will not weigh the relative merits of two systems of accounting, for, as it said in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*, p. 449:

> * * * the direction that net income be computed according to the method of accounting regularly employed by the taxpayer is expressly limited to cases where the Commissioner believes that the accounts clearly reflect income. Much latitude for discretion is thus given to the administrative board charged with the duty of enforcing the Act. Its interpretation of the statute and the practice adopted by it should not be interfered with unless clearly unlawful.

If the petitioner has accurately computed his reserve for future refunds, it is clear that there can be no appreciable difference in a comparison of the two methods over a given period of years. Adherence to the old method will work no hardship on the petitioner, whereas a change in accordance with petitioner's present contention will distort income in the years involved. We submit that the practice now advocated by petitioner is not only unauthorized but is unnecessary.

The petitioner relies upon a number of decisions of this and lower courts. As pointed out above, the application of *United States* v. *Anderson*, 269 U.S. 422, *supra*, and *American National Co.* v. *United States*, 274 U.S. 99, *supra*, is expressly limited by the later decision of this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445, *supra*. The munitions tax involved in the *Anderson* case and the loan bonuses in

the *American National Co.* case were fixed liabilities within the taxable year. Most of the other cases relied upon by petitioner are similarly distinguishable.

In *Virginia-Lincoln Furniture Corporation* v. *Commissioner*, 56 F. (2d) 1028 (C.C.A. 4th), the court permitted the deduction of a reserve, not expressly sanctioned by statute, for discounts on sales made by the taxpayer. The decision is believed to be at variance with the principle announced by this Court in *Lucas* v. *American Code Co., supra.* In any event, the obligation to allow a discount in the event payment is made within a specified time is not analogous to the liability here involved. In the *Virginia-Lincoln Furniture Corporation* case discount and payment were simultaneous, so that the discount could more properly be regarded as one of the factors determining the amount of net income attributable to the operations of the taxable year. At the time income was actually received, it was subject to reduction by the amount of the discount. Here actual receipt and return of the commissions were in no way related.

The petitioner suggests in the alternative that he be permitted to return his income on what he terms the "actuarial" basis, that is, by accruing income derived from overriding commissions over the life of each policy. Under this method, which is sanctioned by Section 246 of the Revenue Act of 1921 only in the case of insurance companies other than life or mutual companies, each policy is assumed to

have been written in the middle of the year and the premiums are apportioned accordingly. (See petitioner's brief, p. 58.)

We question whether this argument is now open to the petitioner, inasmuch as the writ of certiorari was expressly limited to "the question of the deduction on account of reserve" (R. 287); but even if the suggested method be regarded as setting up a reserve for unearned premiums and is therefore within the limitations of the writ, we submit that it is not authorized by statute. Section 246, dealing with certain types of insurance companies, can have no application here. As this Court held in *Bowers* v. *Lawyers Mortgage Co.*, 285 U.S. 182, that section relates to specified classes of taxpayers, and in order to bring itself within the provisions of the section a taxpayer must show that it is an insurance company within the meaning of the Act, which, of course, the petitioner is not.

Nor do the facts of record justify the drawing of an analogy between the petitioner's business and that of an insurance company. In the case of an insurance company the risk assumed is spread over the life of the policy, so that it is entirely proper to apportion the advance premiums accordingly. Here it has not been shown, although the petitioner states it to be a fact (Br. pp. 10–21), that the overriding commissions constituted payment for services rendered throughout the life of the policy. The Board of Tax Appeals, on the other hand, concluded that these commissions represented compensation for services

rendered in the periods covered by the monthly settlements and should be accounted income of those periods. (R. 68.) The Board further pointed out that the multifarious duties of a general agency cannot be attributed to any particular policy written. Certain of these activities relate to the operations of the business as a whole. (R. 68.) Moreover, the firm received as compensation, in addition to the overriding commissions here involved, a percentage of the net profits on business written in its territory. (R. 61.) The petitioner has failed to show what portion of the commissions represented compensation for the performance of miscellaneous duties, as distinguished from the selling and maintenance of individual policies.

Finally, it is to be observed that the suggested actuarial method has not been adopted by the firm either in keeping its books or in making its tax returns, and has not been required by the Commissioner as clearly reflecting income. This reason alone would seem sufficient to preclude the petitioner from insisting at this time that the alternative method of computing its taxable income be accepted.

We submit that the argument as to the actuarial system of accounting, as well as the contention in respect of the reserves for return commissions, might more properly be addressed to Congress than to this Court.

CONCLUSION

The decision of the court below should be affirmed.

Respectfully submitted.

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APPENDIX

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239, provides in part:

> SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.
>
> (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.
>
> * * * * *
>
> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid * * *; * * * or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in

the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *

* * * * *

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

* * * * *

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

* * * * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * *

Sections 212, 213, and 214 of the Revenue Act of 1924, c. 234, 43 Stat. 253, 267–270 (U.S.C., Title 26, Secs. 953–955) and the corresponding sections of the Revenue Act of 1926, c. 27, 44 Stat. 9, 23–27 (U.S.C.

App., Title 26, Secs. 953–955) contain provisions identical with those quoted above.

Treasury Regulations 62 (promulgated under the Revenue Act of 1921) provide in part:

> ART. 22. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. * * *. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 51. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.
>
> ART. 23. *Bases of computation.*—(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. The method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *.

ART. 24. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. * * *.

* * * * *

ART. 32. *Compensation for personal services.*—* * *. Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums * * * are income to the recipients; * * *.

ART. 101. *Business expenses.*— * * *. Other items that may be included as business expenses are reasonable compensation for the services of officers and employees, traveling expenses while away from home solely in the pursuit of a trade or business (see article 101 (a)), advertising and other selling expenses * * *.

ART. 111. *When charges deductible.*—Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. See articles 21–24 and 51. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. But see section 204 and articles 1601–1605. A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a

> going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. * * *.

Articles 22, 23, 24, 32, 101 and 112 of Regulations 65 and 69 contain provisions identical with those quoted above.

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